



*The Law Which Penalizes
Erroneous Refund and Credit Claims
Was Not Properly Implemented*

September 26, 2013

Reference Number: 2013-40-123

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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HIGHLIGHTS

THE LAW WHICH PENALIZES ERRONEOUS REFUND AND CREDIT CLAIMS WAS NOT PROPERLY IMPLEMENTED

Highlights

**Final Report issued on
September 26, 2013**

Highlights of Reference Number: 2013-40-123 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Congress enacted the erroneous claim for refund or credit penalty (referred to as the erroneous refund penalty) to enhance the IRS's ability to address the growing number of erroneous tax credit and refund claims filed. Taxpayers who claim excessive tax credits or refunds may be penalized up to 20 percent of the erroneous tax credit or refund claim. Refund or credit claims that have no reasonable basis in law create unnecessary burden on both taxpayers and the IRS by straining resources and impeding effective tax administration.

WHY TIGTA DID THE AUDIT

The Small Business and Work Opportunity Tax Act of 2007 amended the Internal Revenue Code to allow for a monetary penalty for erroneous tax refund or tax credit claims. This audit was initiated to determine whether the IRS is properly assessing the erroneous claim for refund or credit penalty on individual tax accounts.

WHAT TIGTA FOUND

The IRS incorrectly interpreted the erroneous refund penalty law, which significantly limited the types of erroneous tax refund or credit claims to which the penalty would apply. The IRS assessed only 84 erroneous refund penalties totaling \$1.9 million between May 2007 and May 2012.

In response to concerns raised from various IRS functions, the IRS Office of Chief Counsel

subsequently revised its interpretation of the law as to when the erroneous refund penalty could be assessed, and issued an updated memorandum in May 2012.

Although the IRS revised its interpretation of the law, it has not developed processes and procedures to enable those functions (Campus Operations) that disallow the majority of individual tax credits to assess the penalty. For example, in the year after the IRS revised its interpretation of the law (June 3, 2012 through May 25, 2013), there were 709,123 individual tax credits disallowed by these functional areas for which the IRS could have potentially assessed erroneous refund penalties totaling more than \$1.5 billion.

IRS management raised concerns about the costs and benefits of establishing processes and procedures for the Campus Operations to assess erroneous refund penalties. However, the IRS has not provided any documentation and/or analysis to support the validity of these concerns. In view of the significant problem of erroneous claims for credits and refunds and the related costs to the Government, TIGTA believes that the IRS should reexamine its decision and put appropriate procedures and processes in place to comply with this section of law.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop processes and procedures to enable Campus Operations to assess the erroneous refund penalty for disallowed credit claims that are excessive and do not have a reasonable basis.

The IRS agreed with the recommendation and stated that a cross-functional team of affected stakeholders will determine the operational and procedural changes needed to integrate assessment of the erroneous refund penalty into the Campus Operations.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 26, 2013

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Law Which Penalizes Erroneous Refund and
Credit Claims Was Not Properly Implemented (Audit # 201240040)

This report presents the results of our review of whether the Internal Revenue Service (IRS) is effectively assessing the erroneous claim for refund or credit penalty on individual taxpayer accounts. This audit was conducted as part of our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me if you have questions or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Table of Contents

Background Page 1

Results of Review Page 5

 The Erroneous Refund Penalty Law Was Incorrectly
 Interpreted Page 5

 Processes and Procedures Have Not Been Developed
 to Enable Campus Operations to Assess Erroneous
 Refund Penalties Page 5

Recommendation 1: Page 8

Appendices

 Appendix I – Detailed Objective, Scope, and Methodology Page 10

 Appendix II – Major Contributors to This Report Page 12

 Appendix III – Report Distribution List Page 13

 Appendix IV – Outcome Measure Page 14

 Appendix V – Office of Audit’s Comments on Management’s Response... Page 15

 Appendix VI – Management’s Response to the Draft Report Page 19



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Abbreviations

EITC	Earned Income Tax Credit
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



*The Law Which Penalizes Erroneous Refund
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Background

In its September 30, 2005, Semiannual Report to Congress, the Treasury Inspector General for Tax Administration (TIGTA) reported that certain tax refund schemes were overwhelming Internal Revenue Service (IRS) resources to the point at which the IRS was unable to prevent the issuance of erroneous refunds.¹ The Joint Committee on Taxation expressed a similar concern, stating that the filing of refund claims that have no reasonable basis in law creates unnecessary burden on both taxpayers and the IRS by straining resources and impeding effective tax administration.²

The erroneous refund penalty was created to discourage taxpayers from making erroneous refund or credit claims.

In response to these concerns, Congress enacted legislation that provides the IRS with the erroneous claim for refund or credit penalty (referred to as the erroneous refund penalty) for use as a tool to deter aggressive claims for tax refunds by increasing the cost to individuals who attempt to erroneously claim these refunds. The Small Business and Work Opportunity Tax Act of 2007³ amended the Internal Revenue Code (I.R.C.) to allow for a monetary penalty for erroneous tax refund or tax credit claims. I.R.C. Section (§) 6676 states:

(a) Civil penalty.

If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a penalty in an amount equal to 20 percent of the excessive amount.

(b) Excessive amount.

For purposes of this section, the term “excessive amount” means in the case of any person the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.

¹ TIGTA, *TIGTA Semiannual Report to Congress, April 1, 2005 – September 30, 2005*.

² Joint Committee on Taxation, JCS-2-07, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2008 Budget Proposal* (March 2007).

³ Pub.L. No. 110-28, §§ 8201-8248.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

(c) *Noneconomic substance transactions treated as lacking reasonable basis.*

For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6)⁴ shall not be treated as having a reasonable basis.

(d) *Coordination with other penalties.*

This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.⁵

Prior to the creation of this penalty, there was generally no monetary cost to an individual who submitted a tax return with an erroneous refund or credit claim that the IRS denies before the refund is issued. The penalty could be applied to individuals filing tax returns (including original income tax returns and amended tax returns) after May 25, 2007. The erroneous refund penalty is 20 percent of the excessive refund or credit amount claimed. For example:

Taxpayer A files a tax return claiming a refund of \$5,000. The refund includes \$3,200 in refundable tax credits.⁶ The IRS determines that the individual's claim for the refundable tax credits is erroneous and denies the claim, preventing the individual from receiving the \$3,200. The IRS determines that the entire claim is more than the taxpayer is entitled to receive (excessive) and without a reasonable basis. The IRS can assess an erroneous refund penalty totaling \$640 against this taxpayer (20 percent of the \$3,200 claim).

The law provides certain exemptions from the penalty

In general, the erroneous refund penalty can be assessed on tax returns where the IRS detects an erroneous refund or credit claim at the time the tax return is processed. The law provides an exemption from the erroneous refund penalty for individuals with erroneous claims for refunds or credits that are supported by a reasonable basis. A reasonable basis is established only if the individual can demonstrate that he or she relied on legal authority such as a court ruling or legislative history when making the claim.

⁴ I.R.C. § 6662(b)(6) describes tax benefits that are disallowed due to a lack of economic substance. For a transaction to have economic substance, a taxpayer must have had a substantial reason for entering into the transaction, and the transaction must change the taxpayer's economic position in a meaningful way.

⁵ Part II of Subchapter A of Chapter 68 of the I.R.C. allows for the assertion of certain penalties when the disallowance of a tax item results in an additional tax assessment (underpayment of tax or a tax liability). These penalties include the accuracy-related penalty and fraud penalty.

⁶ A refundable credit can reduce a taxpayer's liability to zero, and any credit amount over the tax liability can be refunded to the taxpayer. In contrast, a nonrefundable credit can only reduce the tax liability to zero.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

In addition, the erroneous refund penalty cannot be assessed if the denied claim was for the Earned Income Tax Credit (EITC). Congress exempted the EITC from this penalty because the I.R.C. already contains specific penalties for taxpayer noncompliance with the EITC.⁷ For example, individuals who incorrectly claim the EITC can be banned from receiving the credit for the next two subsequent tax years if the error is because of reckless or intentional disregard of the rules or may be banned from claiming the EITC for the next 10 subsequent tax years if the error is because of fraud.

Finally, the erroneous refund penalty cannot be assessed if certain other penalties such as the accuracy-related penalty⁸ and/or fraud penalty⁹ apply. The I.R.C. allows for the assessment of other penalties when the disallowance of a credit results in a tax liability. For example, an individual files his or her tax return *and receives* a \$5,000 tax refund. The IRS subsequently determines the individual was not entitled to receive the tax refund and reverses the refund on the individual's tax account, creating a \$5,000 tax liability that the individual must pay. In this instance, the individual would not be subject to the erroneous refund penalty since the disallowance of the refund was subsequent to issuance and resulted in a tax liability. However, this individual could be assessed the accuracy-related and/or fraud penalties.

An IRS study was conducted to determine how best to implement the erroneous refund penalty law in IRS Campus Operations

In November 2008, the IRS completed a study of how best to implement the erroneous refund penalty law within IRS Campus Operations. The study concluded that the IRS should establish a separate unit solely responsible for processing and assessing the erroneous refund penalty. The proposal was to send tax returns that may be subject to the penalty to this new unit for further consideration, regardless of where the tax return was worked originally. IRS management estimated that establishing and maintaining an erroneous refund penalty unit would cost at least \$3.4 million per year and could result in the assessment of \$101 million in penalties each year. However, IRS management cautioned that the estimated cost figures included in the study are understated because they do not include indirect or overhead costs.

The study further concluded that establishing a single unit to review disallowed refund claims and assess the erroneous refund penalty when warranted would assist the IRS in ensuring that the penalty is being applied consistently. In addition, establishing this single unit would allow the IRS to minimize the number of employees it would need to train and the number of processes that would need to be modified. To date no actions have been taken on the part of the IRS to implement the recommendations of the study.

⁷ I.R.C. § 32.

⁸ The IRS can assess an accuracy-related penalty on any portion of an underpayment of tax required to be shown on a tax return. This penalty is generally equal to 20 percent of the underpayment.

⁹ The IRS can assess the fraud penalty if any part of any underpayment of tax required to be shown on a tax return is due to fraud. This penalty is equal to 75 percent of the underpayment.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

This review was performed in the IRS Office of Chief Counsel (hereafter referred to as IRS Counsel) in Washington, D.C.; the Office of Servicewide Penalties in New Carrollton, Maryland; the Small Business/Self-Employed Division Examination function in Washington, D.C.; the Wage and Investment Division Accounts Management function in Atlanta, Georgia; and the Submission Processing Site in Fresno, California, during the period September 2012 through June 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Results of Review

The Erroneous Refund Penalty Law Was Incorrectly Interpreted

The IRS assessed only 84 erroneous refund penalties totaling \$1.9 million between May 2007 and May 2012. Penalties have not been assessed because IRS Counsel incorrectly interpreted the law as to when the IRS had the authority to assess the erroneous refund penalty. Subsequent to the passage of the erroneous refund penalty law, concerns about the lack of clear guidance as to when to assess the penalty were reported by various IRS functions to the Office of Servicewide Penalties.¹⁰ In response, IRS Counsel issued a memorandum in November 2009 stating that the disallowance of a refundable tax credit generally resulted in a tax liability regardless of whether the tax credit was disallowed before or after the related tax refund was issued.

The IRS incorrectly interpreted the law as to when the erroneous refund penalty applies. Consequently, only 84 penalties have been assessed between May 2007 and May 2012.

The guidance in the November 2009 memorandum was an incorrect interpretation of the legislation because it concluded that disallowing a refundable tax credit before the refund was issued resulted in a tax liability to the taxpayer. This incorrectly prevented the

IRS from assessing the erroneous refund penalty on these disallowed credits. In May 2012, IRS Counsel revised its interpretation as to when a tax liability exists with regard to the erroneous refund penalty and issued an updated memorandum. This new guidance stated that erroneous refundable tax credits that are disallowed before a tax refund is issued will generally not result in a tax liability and, therefore, will be subject to the erroneous refund penalty. This guidance significantly expanded the number of taxpayers to whom the penalty applied. The IRS indicated that the incorrect interpretation contained in the November 2009 memorandum occurred because a Treasury Regulation that provided guidance on this subject was not clear.¹¹

Processes and Procedures Have Not Been Developed to Enable Campus Operations to Assess Erroneous Refund Penalties

Although the IRS revised its interpretation of the law as to when the erroneous refund penalty applies, it has yet to develop processes and procedures to enable those IRS functions that disallow the majority of individual tax credits to assess the erroneous refund penalty when

¹⁰ The IRS office that provides coordination of policy and procedures concerning the administration of all IRS Civil Penalty programs.

¹¹ Treasury Regulation § 1.6664-2. Underpayment.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

applicable. These Campus Operations functions include the Submission Processing function, Accounts Management function, Return Integrity and Correspondence Services function, and Campus Examination function. In the year after the IRS revised its interpretation of the law (June 3, 2012, through May 25, 2013) there were 709,123 individual tax credits¹² totaling more than \$7.5 billion disallowed by these functional areas. Applying the 20 percent erroneous refund penalty rate to the total credit amount disallowed computes to more than \$1.5 billion in penalties that potentially could have been assessed.¹³ Figure 1 provides a summary of credits disallowed.

Figure 1: Summary of Tax Credits Disallowed – June 2012 Through May 2013¹⁴

Type of Disallowed Refund	Taxpayer Accounts	Disallowed Claims	Disallowed Amount	I.R.C. § 6676 Penalty Amount
Withheld Taxes	388,895	388,895	\$6,744,111,249	\$1,348,822,250
Refundable Credits	69,804	73,264	\$126,273,533	\$25,254,707
<i>Additional Child Tax Credit</i>	43,463	43,463	\$57,773,219	\$11,554,644
<i>Refundable Education Credit</i>	16,309	16,309	\$16,336,559	\$3,267,312
<i>Adoption Credit</i>	1,503	1,503	\$13,077,004	\$2,615,401
<i>Other Refundable Credits¹⁵</i>	11,946 ¹⁶	11,989	\$39,086,751	\$7,817,350
Claims for Withheld Taxes and Refundable Credits	120,257	246,964	\$680,099,193	\$136,019,838
Total	578,956	709,123	\$7,550,483,975	\$1,510,096,795

Source: TIGTA analysis of the IRS's Individual Master File.¹⁷

In December 2010, based on its prior interpretation of the law, the IRS issued procedures for assessing the erroneous refund penalty for use by the IRS's Field Examination function.¹⁸

¹² We did not include tax credits disallowed for tax returns involving identity theft.

¹³ The determination as to whether a penalty will be assessed is dependent on the conditions surrounding the disallowance of the tax refund or credit for each individual tax return.

¹⁴ The totals in this chart are taxpayer accounts/returns rather than individual credits. The taxpayer accounts total does not add to the 709,123 individual tax credits disallowed because some taxpayers claimed multiple refundable tax credits that were disallowed.

¹⁵ These other refundable credits include: Health Care Coverage Tax Credit, Telephone Excise Tax Credit, Refundable Credit for prior year minimum tax, Economic Stimulus Payments, First-Time Homebuyer Credit, Making Work Pay Credit, RRTA [Railroad Retirement Tax Act] Tier 1 Credit, Tax Withheld At Source, Tax Withheld Section 1446, and Adjustments to Form 8288-A [*Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*] Withheld.

¹⁶ Some taxpayers claimed multiple refundable tax credits that were disallowed.

¹⁷ The IRS database that maintains transactions or records of individual tax accounts.

¹⁸ The IRS function responsible for examinations of individuals, partnerships, and corporations that occur either at the taxpayer's place of business or through interviews at an IRS office.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

However, after the IRS revised its interpretation of the law in May 2012, the majority of tax returns likely to be subject to the penalty are those tax credit claims that are disallowed by the IRS Campus Operations. As such, the IRS is not able to comply with the requirements of the law.

Some of the 578,956 tax returns we identified with disallowed credit claims could be the result of individuals filing a fraudulent tax return. For these types of tax returns, the collectability of the assessed penalties may be diminished. However, IRS guidance states that the purpose of penalties is to encourage voluntary compliance by imposing consequences for noncompliance. If the erroneous refund penalty is not assessed when applicable, there is nothing to deter these taxpayers from repeatedly filing excessive erroneous credit claims. As a result, individuals will continue to make questionable claims on their tax returns, burdening IRS resources and increasing the cost of addressing taxpayers' noncompliance. These are the individuals that the law was intended to penalize.

Management could not provide support for its decision to forego the processes and procedures necessary for Campus Operations to assess these penalties

IRS management raised concerns about the costs and benefits of establishing processes and procedures for the Campus Operations to assess erroneous refund penalties. Management was concerned that expanding the ability to assess the penalty to these functions could result in:

- Significant costs to develop new processes and procedures and train IRS employees.
- Having to shift limited resources from existing compliance programs, which may actually hinder rather than improve compliance.
- Increased taxpayer burden because of inconsistent treatment of taxpayers when assessing the penalties.

On June 19, 2012, based on the above concerns, the IRS decided that it would not develop processes and procedures necessary to assess the erroneous refund penalty. The IRS has not provided any documentation and/or analysis to support the validity of these concerns. In view of the significant problem of erroneous claims for credits and refunds and the related costs to the Government, we believe that the IRS should reexamine its decision and put appropriate procedures and processes in place to comply with this section of law.

Applying the penalty to the excess credit amount provides a more consistent application of the penalty

The law allows the IRS to assess the penalty on either the excess refund amount or the excess credit amount. Our analysis of the 84 tax accounts on which the IRS assessed the erroneous refund penalty of \$1.9 million during the period May 2007 to May 2012 found that the IRS



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

assessed the penalty using the excess credit amount.¹⁹ In our opinion, assessing of the penalty on the excess credit amount results in a more consistent treatment of taxpayers. As such, this is the method we used to compute the potential amount of penalties that could be assessed. Figure 2 illustrates the difference between assessing the penalty on the excess credit amount and the excess refund amount.

Figure 2: Illustration of the Assessment of the Erroneous Refund Penalty

	Taxpayer A	Taxpayer B
Disallowed Refundable Credit Amount	\$1,000	\$1,000
Tax Liability	\$500	\$0
Tax Refund Amount Associated With the Disallowed Refundable Credit <i>(excess of the refundable credit over tax liability)</i>	\$500	\$1,000
Erroneous Refund Penalty:		
Assessed on the Disallowed Credit <i>(20% x disallowed credit amount)</i>	\$200	\$200
Assessed on the Excess Refund <i>(20% x tax refund associated with the disallowed credit)</i>	\$100	\$200

Source: Hypothetical illustration based on TIGTA's analysis of I.R.C. § 6676 and erroneous refund penalties assessed by the IRS between May 2007 and May 2012.

Assessing the penalty using the excess refund amount causes the erroneous refund penalty amount to vary based on an individual's tax liability. Individuals with a higher tax liability who erroneously claim a credit will be assessed a lower erroneous refund penalty compared to individuals who have a lower tax liability, resulting in an inconsistent application of the penalty.

Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should develop processes and procedures to enable Campus Operations to assess the erroneous refund penalty for disallowed credit claims that are excessive and do not have a reasonable basis.

Management's Response: The IRS agreed with our recommendation. A cross-functional team of affected stakeholders will determine the operational and procedural changes needed to integrate assessment of the erroneous refund penalty into

¹⁹ The IRS assessed the erroneous refund penalty on the disallowed credit amount in 42 of the 84 tax returns. A lack of data prevented us from determining how the IRS calculated the penalty amount on the remaining 42 returns.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

the campus environment. Consideration will be given to the administrative policy, available resources, funding needs, and opportunity costs associated with the redirection of compliance resources. The corrective action will be closed upon presenting the team's findings and recommendations to the Office of the Deputy Commissioner for Services and Enforcement.

Office of Audit Comment: Although the IRS agreed to take corrective action in response to this recommendation, it did not agree with the related outcome measure. However, we believe the IRS's comments providing the rationale for its disagreement are factually inaccurate. We provide our perspective on the IRS's comments in Appendix V.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS is effectively assessing the erroneous claim for refund or credit penalty on individual taxpayer accounts. To accomplish our objective, we:

- I. Evaluated the adequacy of the controls for ensuring that the I.R.C. § 6676 penalty (hereafter referred to as the erroneous refund penalty) is properly considered and applied during examinations of erroneous claims for refunds or credits.
- II. Determined if the IRS was assessing the erroneous refund penalty on cases to which the penalty may apply and the potential tax effect of nonassertion.
 - A. Obtained an extract from the Individual Master File¹ maintained on the TIGTA Data Center Warehouse² to identify tax returns filed between June 3, 2012, and May 25, 2013, for which a claim for a tax credit was disallowed before the refund was issued and for which no erroneous refund penalty was assessed. We filtered the data to include only those disallowed claims that were \$500 or more, were not assessed an accuracy-related penalty or fraud penalty, and did not have indications of identity theft. We also eliminated disallowed refundable credits that were filed using an Internal Revenue Service Number.
 - B. Validated our data by comparing a random sample of 25 records to the IRS's Integrated Data Retrieval System³ and determined that the data were sufficiently reliable for purposes of this report.
 - C. Analyzed the 84 tax returns on which the erroneous refund penalty was assessed by the IRS between May 2007 and May 2012 and determined how the penalty amount was calculated.
- III. Assessed the status of ongoing changes to the erroneous refund penalty. We interviewed IRS management and policy analysts to identify ongoing changes (policy and procedural changes, training, *etc.*) that would have an impact on the assertion of the erroneous refund penalty and evaluated the effectiveness of those changes.

¹ The IRS database that maintains transactions or records of individual tax accounts.

² The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits.

³ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS's policies, procedures, and practices related to the consideration and assessment of the erroneous refund penalty. We evaluated these controls by reviewing tax returns where the erroneous refund penalty appears to be applicable to ensure that the penalty was assessed.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix II

Major Contributors to This Report

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*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix III

Report Distribution List

Acting Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Office of the Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Operations, Wage and Investment Division SE:W
Deputy Commissioner, Support, Wage and Investment Division SE:W
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFC:CPIC:IC
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$1,510,096,795 (\$7,550,483,975 over five years) in unassessed I.R.C. § 6676 penalty assessments on 578,956 taxpayer accounts from June 3, 2012, to May 25, 2013 (see page 5).

Methodology Used to Measure the Reported Benefit:

From the IRS Individual Master File,¹ we obtained a computer extract of disallowed refundable tax credits claimed between June 3, 2012, and May 25, 2013. We used the following criteria to identify the erroneous refund penalties that should have been assessed during that time period:

1. Prerefund Disallowance – We included only erroneous credit claims that the IRS denied before the refund was issued by comparing the date of the disallowed refundable tax credit to the date of the tax refund (if any).
2. No Other Applicable Penalties – We excluded tax returns where the accuracy-related penalty, the fraud penalty, or the erroneous refund penalty had already been assessed.
3. No Identity Theft – We excluded tax returns where there was an indication of identity theft on the entity module.

Using these criteria, we identified 709,123 disallowed tax credits claimed on 578,956 tax returns for which erroneous refund penalties could have been potentially assessed by the IRS. The amount of erroneous credits disallowed by the IRS totaled \$7,550,483,975. We multiplied 0.20 (20 percent penalty) by the total disallowed amount of \$7,550,483,975 and calculated \$1,510,096,795 in potential erroneous refund penalty assessments that the IRS could have made between June 3, 2012, and May 25, 2012. We estimate the IRS may not assess \$7,550,483,975 (\$1,510,096,795 x 5) in erroneous refund penalties over the next five years.²

¹ The IRS database that maintains transactions or records of individual tax accounts.

² This estimate is based on refundable tax credits contained in the I.R.C. at the time of our review. Some refundable tax credits may expire within the next five years. In addition, Congress may enact additional refundable tax credits within the next five years.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix V

Office of Audit's Comments on Management's Response

The IRS agreed to the recommendation in this report and plans to take corrective action. However, in its response, IRS management also provided some general comments and assertions that we believe are factually inaccurate. We provide our perspective on the IRS's comments below.

IRS Assertion: *The corrective action, whether accomplished manually or through automation, will have associated costs (both direct and opportunity) substantially higher than the estimated annual direct labor costs of \$3.4 million cited in the report.*

Office of Audit Comment: As stated in the report, the \$3.4 million estimated annual cost to establish and maintain an erroneous refund penalty unit was an estimate by the IRS, not TIGTA. This estimate was included in an IRS study completed in November 2008. The IRS provided no documentation or analysis during the audit supporting its assertion of the significant costs to develop new processes and procedures.

IRS Assertion: *The determination of reasonable basis is a judgmental decision based on a review of the position taken on the return and all applicable supporting authorities for the position. In a declining budget environment, this will require the reassignment of examiners from other critical priority compliance work, such as identity theft and refund fraud.*

Office of Audit Comment: We discussed the reasonable basis standard with IRS Counsel on January 15, 2013. IRS Counsel indicated that the reasonable basis standard is a relatively high standard to meet and it is unlikely that many taxpayers meet that standard. Further, IRS Counsel informed us that if a reasonable basis defense is not shown with the claim for refund or credit when the tax return is filed, the IRS can legally assess the penalty immediately and without any correspondence with the taxpayer. As such, it is unlikely that the IRS would need to reassign examiners from other critical work to make a determination as to reasonable basis.

IRS Assertion: *We disagree with the projected Outcome Measure of \$7.6 billion in the report because it is based on a fundamental legal misunderstanding of the difference between a "claim for refund or credit" and a "refundable credit" within the meaning of the Internal Revenue Code.*

Office of Audit Comment: The projected outcome measure is fully consistent with Internal Revenue Code Section 6676. I.R.C. Section 6676 states that the erroneous refund



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

penalty can be assessed on an excessive claim for refund *or* an excessive claim for credit. As noted on page seven in the report, our outcome measure is computed using the excessive claim for credit and is consistent with IRS guidance provided to its field functions regarding penalty application. Furthermore, as we have detailed in our report, assessing the erroneous refund penalty using the excess refund amount would result in the inconsistent treatment of taxpayers as shown in Figure 2 on page eight of the report.

IRS Assertion: *In addition, more than one-half of the 578,956 accounts upon which the \$7.6 billion projection is based were found to have been identified as potentially fraudulent returns by the Electronic Fraud Detection System (EFDS). Common characteristics of these returns such as no response from the taxpayers, an inability to confirm wage and withholding amounts with employers, and the subsequent elimination of the reported wage and withholding amounts indicate the returns were not filed by the taxpayer. Similar characteristics were found with those returns that had been referred to pre-refund examination where other refundable credits, in addition to false withholding credits, had been claimed. These attributes strongly suggest that the denied refund claims were not filed by the individuals to whom the Social Security Numbers had been assigned. Penalties imposed on these returns are not appropriate and would have no effect on voluntary compliance as the filer of the fraudulent return is unknown to the Service and would result in additional administrative costs incurred to abate them in the event a positive determination is made that identity theft has occurred.*

Office of Audit Comment: We agree that the erroneous refund penalty should not be imposed on tax returns that are the result of identity theft. As such, the 578,956 tax returns on which our outcome is computed **do not** include tax returns that, at the time of our review, contained any of the specific identity theft codes the IRS uses to designate a tax return as potential or confirmed identity theft. This fact is included in footnote 12 on page six of our report.

IRS Assertion: *We also disagree with the statement that the Treasury Inspector General for Tax Administration (TIGTA) has made in the report that IRS management has disregarded its responsibility for establishing processes and procedures for assessing the erroneous claim penalty. At the time the penalty provisions were enacted, and afterward, the IRS faced an unprecedented year-by-year increase in the number of fraudulent claims for refund by unscrupulous individuals. Identifying and stopping those fraudulent claims has been the foremost priority.*

Office of Audit Comment: As noted in our report, the unprecedented growth in erroneous and fraudulent tax credit claims that the IRS refers to was the driving factor for the enactment of the erroneous refund penalty. Congress enacted the erroneous refund penalty in May 2007 in response to concerns raised by the Joint Committee on Taxation and TIGTA with regard to the impact of the growth in erroneous and fraudulent claims on both taxpayers and the IRS. Implementing the penalty should have been an integral part of the IRS efforts to combat these improper claims.



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

IRS Assertion: *Moreover, we disagree with the characterization that erroneous Chief Counsel advice, which was later corrected, caused any failure to implement the section 6676 penalty.*

Office of Audit Comment: As we noted in the report, the original advice issued by IRS Chief Counsel in November 2009 incorrectly stated that the disallowance of an erroneous refundable credit prior to the issuance of the tax refund results in a tax liability. I.R.C. § 6676 states:

This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.

Part II of Subchapter A of Chapter 68 of the Internal Revenue Code allows for the assertion of certain penalties when the disallowance of a tax item results in an additional tax assessment (underpayment of tax or a tax liability). As such, Chief Counsel's November 2009 guidance generally excluded any refundable tax credit that was disallowed before the refund was issued from the erroneous refund penalty. Consistent with the November 2009 guidance, the IRS did not develop procedures to assess the erroneous refund penalty in its Campus Operations, where most erroneous refund and credit claims are disallowed prior to issuance of the refund. The incorrect guidance remained in place from May 2009 to May 2012, when Chief Counsel reversed its position with regard to the existence of a tax liability when a tax refund or credit claim is disallowed prior to the issuance of a refund.

IRS Assertion: *Finally, it is misleading to report that IRS management decided on June 19, 2012, that it will not assess the erroneous refund penalty at Submission Processing Site functions. The communication to which the TIGTA refers was guidance provided by an analyst in response to questions the campuses had raised after the Chief Counsel advice had been issued in May 2012.*

Office of Audit Comment: The documentation supporting the statement included in our report was provided to us by a program manager during a visit at one of the IRS campuses. Although the original email containing the guidance was initiated by a program analyst, the wording makes clear that the Wage and Investment and Small Business/Self-Employed Divisions coordinated on a response to the program managers to confirm that the erroneous refund penalty would not be assessed by Campus Operations. We have discussed this issue with IRS management previously and they have never stated that the email was unauthorized or inaccurately conveyed management's decision.

The June 19, 2012, communication was sent to various campus program managers and states the following:



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Good afternoon:

Several campuses have asked if Exam should assert the IRC 6676 penalty on non-EITC cases with frozen refunds. The Campuses asked this question in response to Counsel's memorandum. The memorandum stated that taxpayers might be liable for a penalty under IRC 6676.

Wage and Investment and SBSE have discussed this issue and agree that the IRC 6676 penalty should not be assessed at the Campus level because:

- 1. The penalty cannot be assessed via RGS [Report Generation Software]*
- 2. The penalty must be assessed using MFT [Master File Tax] 55, and*
- 3. A separate penalty file must be created whenever the IRC 6676 penalty is asserted. (The penalty file is not established on AIMS [Audit Information Management System])*



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Appendix VI

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

SEP 09 2013

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Law Which Penalizes Erroneous
Refund and Credit Claims Was Not Properly Implemented
(Audit # 201240040)

We appreciate the opportunity to review the subject draft report and to provide our comments on the findings. Penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code and, for most taxpayers, voluntary compliance consists of preparing an accurate return, filing it timely, and paying any tax due.

While the IRS has implemented enforcement of the provisions of Internal Revenue Code section 6676, *Erroneous claims for refund or credit*, in our field audit operations, we recognize that additional actions can be taken to identify appropriate campus operations where the penalty should be considered. However, as noted in the report, there are significant concerns regarding the costs associated with implementing enforcement of the penalty provisions within the campus environment. The section 6676 penalty may be appealed administratively but, unlike income tax and certain other penalties cannot be considered by the Tax Court in a normal deficiency context. This nuance renders the penalty assessment incompatible with existing automated campus-based compliance processes. The corrective action, whether accomplished manually or through automation, will have associated costs (both direct and opportunity) substantially higher than the estimated annual direct labor costs of \$3.4 million cited in the report.

Taxpayers may avoid the penalty for any denied claim in which they have a reasonable basis. The determination of reasonable basis is a judgmental decision based on a review of the position taken on the return and all applicable supporting authorities for the position. In a declining budget environment, this will require the reassignment of



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

2

examiners from other critical priority compliance work, such as identity theft and refund fraud.

We disagree with the projected Outcome Measure of \$7.6 billion in the report because it is based on a fundamental legal misunderstanding of the difference between a "claim for refund or credit" and a "refundable credit" within the meaning of the Internal Revenue Code and related regulations. "Claim for refund or credit" or "claim for credit or refund" in this context means the request that the taxpayer makes for the IRS to return an identified overpayment of tax for a particular tax period. A "claim for credit or refund" does not mean a claim to one or more refundable tax credits (for example, first-time homebuyer credit, additional child tax credit, etc.) located in subpart C of the Code because a claim of a refundable credit does not necessarily indicate that there is a claimed overpayment on the return.

In addition, more than one-half of the 578,956 accounts upon which the \$7.6 billion projection is based were found to have been identified as potentially fraudulent returns by the Electronic Fraud Detection System (EFDS). These returns were flagged by EFDS for additional scrutiny by Tax Examiners prior to the claimed refunds being issued. Common characteristics of these returns such as no response from the taxpayers, an inability to confirm wage and withholding information with employers, and the subsequent elimination of the reported wage and withholding amounts indicate the returns were not filed by the taxpayer. Similar characteristics were found with those returns that had been referred for pre-refund examination where other refundable credits, in addition to false withholding credits, had been claimed. These attributes strongly suggest that the denied refund claims were not filed by the individuals to whom the Social Security Numbers had been assigned. Penalties imposed on these returns are not appropriate and would have no effect on voluntary compliance as the filer of the fraudulent return is unknown to the Service and would result in additional administrative costs incurred to abate them in the event a positive determination is made that identity theft has occurred.

We also disagree with the statement the Treasury Inspector General for Tax Administration (TIGTA) has made in the report that IRS management has disregarded its responsibility for establishing processes and procedures for assessing the erroneous claim penalty. At the time the penalty provisions were enacted, and afterward, the IRS faced an unprecedented year-by-year increase in the number of fraudulent claims for refund by unscrupulous individuals. Identifying and stopping those fraudulent claims has been the foremost priority. Moreover, we disagree with the characterization that erroneous Chief Counsel advice, which was later corrected, caused any failure to implement the section 6676 penalty.

Finally, it is misleading to report that IRS management decided on June 19, 2012, that it will not assess the erroneous refund penalty at Submission Processing Site functions. The communication to which the TIGTA refers was guidance provided by an analyst in



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

3

response to questions the campuses had raised after the Chief Counsel advice had been issued in May 2012. Afterward, executives from the Wage and Investment and Small Business/Self Employed Divisions met with the TIGTA management to discuss potential corrective actions.

Attached are our comments to your recommendation. If you have any questions, please contact me, or a member of your staff may contact Steve Klingel, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-9085.

Attachment



*The Law Which Penalizes Erroneous Refund
and Credit Claims Was Not Properly Implemented*

Attachment

Recommendation

Recommendation 1

The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should develop processes and procedures to enable Campus Operations to assess the erroneous refund penalty for disallowed credit claims that are excessive and do not have a reasonable basis.

Corrective Action

A cross-functional team of affected stakeholders will determine the operational and procedural changes needed to integrate assessment of the erroneous refund penalty into the campus environment. Consideration will be given to administrative policy, available resources, funding needs and opportunity costs associated with the redirection of compliance resources. The corrective action will be closed upon presenting the team's findings and recommendations to the Deputy Commissioner for Services and Enforcement.

Implementation Date

October 15, 2014

Responsible Official

Director, Reporting Compliance, Wage and Investment Division

Corrective Action Monitoring Plan

We will monitor this corrective action as part of our internal management control system.